Insights in Capital Raising for Private Funds

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Sometimes a fund manager comes up to us and asks: I've mastered how to make money managing assets. I'm a smart guy and I've made millions from my own assets and now I've been on the capital raising trail for a while. I had no luck in raising any external funds. I've tried some standard and tested ways; hired an internal marketer, got my materials up to date and talked at a few events. So, what is the secret sauce in capital raising for funds? How do you break the formula?

What is the Secret Sauce in Capital Raising for Funds?

Discussions like this have prompted us to share some of our insights in the fund capital raising business. This paper is aimed at the new or more established managers alike, and at the end you find our answer to the fund manager's question.

So, What is the First Thing to Consider in Capital Raising?

1. Know Your Investor

It should start with the investor, and his/her investment profile, investor preferences and needs. In any investor discussion, the manager should ask or find out these things. It's like people going to the butcher to buy meat, not milk. You need to find out what the investor is looking for in the first place.

2. Anchor LPs and Network

There must be a strategic fit, such like finding an investor looking for a specific geographic mandate, size of fund, liquidity needs, or a special investment strategy. It also helps to have a tactical fit, like great personal match with the investor representative or sharing past work relationships or having the kids in the same school for a bit of extra trust. These items are even more important for smaller funds seeking anchor investors.

We are amazed how often fund managers talk straight for 30 minutes in meetings, and skip any questions to the investor. If it's a first introductory meeting, take 5-10 minutes to have the investor introduce themselves and their investment activities.

Is There a Road Map to Successful Capital Raising?

In today's crowded market, having a specialized investment strategy is key, and everything springs from it. A manager needs to be able to withstand competition from passive strategies like ETFs and mutual funds, as well as other active funds. We think it is pretty clear that an L/S Equity fund focusing on US large caps with 2/20 fees and 3+ months liquidity – as well as a track that is below its index – will struggle. What we see is that these funds typically survive on a few legacy accounts, but find it very hard in raising new capital.

3. Is Your Strategy Unique *Enough*?

On the other hand, an investment strategy which captures a market which has some barriers to entry, either by access to assets, investment sophistication or specialization, should be able to carve out some 'above margin' profits and provide something unique to investors. A few examples of this could be credit funds like Direct Lending, Trade Finance or High Yield, geographical coverage like Frontier Markets/EM, sector specialization funds in Healthcare, Microcap or Financials, some Quantitative, overlay or Event Driven funds, or hard asset funds like Real Estate.

4. Review the Competition and Your Position in it

One could argue that a 'superstar' fund manager is also providing barriers to entry, like Saba Capital's Boaz Weinstein or David Einhorn's Greenlight Capital, but these keyman bets, usually run as Macro strategies, seem to be diminishing in relevance. The point here is that really no-one is able to beat the markets, however, a uniquely crafted strategy focusing on a relatively underserved part of the markets might enjoy some 'supernormal' opportunities.

Remember that the investment strategy should be consistent over time, without any style drift. This allows investors knowing what product they are getting, and benchmark the fund to relevant indices and other funds across time.

For all those funds out there finding their market crowded and investor appetite declining: go back to the drawing board, consider starting a new fund with a new, unique investment strategy.

The Sweat Equity

5. Are You Able to Commit Personal Resources and Having the Skills?

Setting up and running an investment fund is like other growing businesses. You need a team, solid service providers, an online due diligence room, shiny and up to date marketing materials. We think what many small to medium sized fund managers forget is that it is a venture proposition, and you might need to absorb losses and lower fees substantially to be successful. We usually use the analogy of starting a restaurant, where you might have 50% of your seats empty the first period, and you need to personally walk around the place making sure napkins are properly folded. There is probably a culture problem, where many fund managers might be reasonably affluent and coming from well-paid, comfortable roles. And then they expect investors to start calling them – well it won't happen.

6. Is the Business Institutionalized *Enough*?

The Tools and Science of Marketing a Fund

There are three things that we want to focus on here: it's a long game, try different approaches to active marketing, and make sure to follow up.

The standard ways to market funds include newsletters, educational briefs, conference and event engagements, industry databases and online tools, using intermediaries like 3rd party marketers and prime brokers, and hiring an in-house marketer or using your personal network. See the Laundry List at the end of this document.

One could discuss which marketing strategy is more efficient – usually funds have their very specific preferences - but we think the most important thing is to **keep marketing pressure up**. Truth is, marketing funds is a slog and a grind, and you need to keep at it. You need to keep prospective leads coming in the pipeline. While most investors will dismiss you, the ones with a good match will usually be very happy to start a conversation, and are grateful for your efforts.

7. Create a Strategic Marketing Plan and Pick Your Marketing Methods

Which brings us to the second point: this is a long game. Marketing and closing cycles are counted in quarters, if not years. However, once your fund may experience a successful capital raising 'streak', it is important not to become complacent. What we see sometimes is that when a particular fund or strategy is amassing investors during say a six months period, they start to become picky on investors. Don't. Welcome them all in, without a fuzz, while you are on a roll.

And finally, remember to follow up on that meeting or call. We can't count how many times we have spoken to an investor after an introduction, and their feed-back about the fund is favorable but they either can't reach the fund or have not heard back from them. So, it's wise to invest in a CRM which systematizes leads and follow ups.

What about branding? Well, for our segment of funds we don't think classic business branding matters that much. The vast majority of the private funds industry is operated by small teams, where 'personal branding' is more important than a fancy logo or having symmetrical fonts throughout the firm. How the PM is perceived in the sector and his background say a lot more. Still, business branding adds to the professional impression of a fund.

8. Personal Branding of Portfolio Manager

What About Performance?

Yes, of course performance is important, but it needs to be evaluated against the risk assumed, which is tied to the applicable investment strategy. Market cycles play a big factor too, with for example the US equity markets approaching a 10-year bull run, resulting in that long-biased funds might look pretty good in 2017 while market neutral funds have struggled. Some quant funds may have excellent track records after an extended period of low volatility, but they risk to only be great until the next market shakedown, when their models are challenged.

Our key takeaways here are that any pre-fund track record is not worth much, and that a fund must, in fact, make more money for its investors relative to other comparable investment destinations in order to be successful in the medium-to-long run. This stretch of time should include one or more stress periods, with 2008 being the Mother of stress tests. In short, funds that are not able to add enough value, the 'alpha' in the industry's jargon, will struggle and are likely to flounder. A broader discussion of investor returns and fund alpha can become a bit of an academic topic, which has been discussed by the AIMA organization and Simon Lack in the 'Hedge Fund Mirage' among others, and is not the aim of this paper.

9. Is Performance Competitive *Enough*?

We think as investors can't know which funds are the best performing until after the fact, they should concentrate on variables they can control, like negotiating fees, and getting exposure to tactical parts of the market, like parts of Europe in 2017 or distressed debt in the energy sector a while ago, and may need an active manager to do this. It is a sound strategic and tactical allocation process when you use a manager for a market opportunity with the selected manager also having a solid business and decent track, the PM having a personal brand, as well as running an active marketing strategy to facilitate the relationship.

While the fund management marketplace has become more commoditized, investing in a fund manager remains a bet on their business acumen, investment skills and, arguably, for being on the right side of lucky.

Going back..

So, let’s go back to our fund manager struggling to raise capital. We’d give him two options: keep up the marketing efforts you are doing, with a few tweaks probably related to the type of investors you talking to. It’s a long game and you have to keep at it.

Another option would be, since the manager manages about $50m of his own assets, to focus only on performance and basically run a family office without external capital. Performing at 15% would mean a bottom-line of over $7m, and itself a way to grow the fund (with a 100% performance fee!). You would not have the need for any external investor reporting, conference calls, marketing trips and other time-consuming and expensive tasks.

Which option to choose is mostly a personal choice by the manager for what strategic direction he wants the firm to take.

The Private Fund Capital Raising Laundry List

Strategic Items

1. Know your investor
2. Anchor LPs and network
3. Is the investment strategy unique *enough*?
4. Review the competition and your position in it
5. Are you able to commit personal resources and having the skills?
6. Is the business institutionalized *enough?*
7. Create a Strategic Marketing Plan and pick your marketing methods
8. Personal branding of PM
9. Is performance competitive *enough*?

Tactical Items

- Newsletters and fund summary
- One-minute elevator pitch 'for grandma'
- Online educational briefs, white papers, articles
- Online presence: website, linkedin, blogs
- Online industry databases
- Videos and interviews
- Cap intro events and conferences
- Internal marketer
- 3rd party marketer
- Online due diligence data room
- Founders share class
- CRM system for follow ups
- Business branding
- References

About the Author

Carl Berg runs Catalyst Financial Partners, an investor events firm for the private funds industry. The firm links alternative investment managers and investors together through investor events. It has established itself as one of the leading, independent cap intro providers. He also works with selected alternative investment firms in a capital raising capacity and consults with investors on their allocation needs and manager search mandates.

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